Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:MAN:TL-N-2689-00
CMBaerga/RLPeacock

date:

to: Chief, Examination Division, Manhattan
Attn: Andrew Yeancates, Revenue Agent

from: District Counsel, Manhattan

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subject: [redacted]
Taxable years ending [redacted], [redacted], [redacted], [redacted], [redacted] and [redacted]

U.I.L. No.: 162.07-01

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Issue

Whether [redacted], is entitled to deduct the compensation it paid to [redacted] for taxable years [redacted] through [redacted] and to [redacted] for taxable years [redacted] and [redacted]/, pursuant to I.R.C. § 162(a).

Background

The Manhattan District is currently examining the income tax returns of [redacted] (E.I.N. [redacted], for the taxable years ending May 31, [redacted] though May 31, [redacted]/. At issue is whether [redacted] is entitled deduct compensation it paid to [redacted] the company's president and chairman, in the amounts of $[redacted], $[redacted], $[redacted], $[redacted] $[redacted] and $[redacted] for taxable years [redacted] and [redacted] respectively. Also at issue is whether [redacted] is entitled to deduct compensation it paid to [redacted], who has held various positions at [redacted], in the amounts of $[redacted] and $[redacted] for taxable years [redacted] and [redacted] respectively.

[redacted] is a closely-held corporation registered as a broker/dealer with the Securities and Exchange Commission. Its main business activity is trading convertible bonds and underlying stocks for its own account. [redacted] is based in [redacted] New York. It was formerly known as [redacted] and [redacted], a company founded and run by [redacted] and [redacted] When [redacted] left the firm and [redacted] retired in the mid-[redacted] became the company's president. [redacted] was [redacted]'s president and chairman of the board during taxable years [redacted] through [redacted]

[redacted] provided the following information in response to an IDR: he graduated from [redacted] and is [redacted] years old. He has been involved with [redacted] and the securities industry for approximately [redacted] years. His primary

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1/ [redacted] paid [redacted] non-employee compensation in the amounts of $[redacted], $[redacted] and $[redacted] for taxable years [redacted] and [redacted] respectively. The Manhattan District concedes that these amounts of compensation were reasonable.

2/ In [redacted], revenue agent George Hasselgrin completed his audit of the taxable years ending May 31, [redacted] and May 31, [redacted] paid [redacted] $[redacted] and $[redacted] for taxable years [redacted] and [redacted] respectively. According to Hasselgrin's RAR, he determined that $[redacted] was reasonable compensation for [redacted] for each year. [redacted] did not receive any compensation from [redacted] during [redacted] and [redacted] These years are currently assigned to appeals officer Jerry Katz in Manhattan.

areas of expertise include trading, research, portfolio management, sales, legal, compliance and management. Prior to [redacted], [redacted] spent [redacted]% of his time trading, [redacted]% of his time researching, [redacted]% of his time on portfolio management, [redacted]% of his time on sales, [redacted]% of his time on software development and programming, and [redacted]% of his time on management. After [redacted], [redacted] spent [redacted]% of his time trading, [redacted]% of his time researching, [redacted]% of his time on portfolio management, [redacted]% of his time on [redacted], [redacted]% of his time on management and [redacted] time on sales. The revenue agent who examined taxable years [redacted] and [redacted], however, determined that at least [redacted]% of [redacted]'s time was devoted to managerial activities.

Regardless of the time he spends on each activity, [redacted] works long hours, from approximately [redacted] p.m. in the office, and an additional three hours at home each night. Both the revenue agent and the taxpayer's representative agree that [redacted] is an expert in the securities industry, and that the success of [redacted] is largely due to [redacted]'s knowledge and efforts.

From the [redacted] to present, [redacted] has held several positions at [redacted]. According to a letter from [redacted], prior to [redacted], [redacted] was primarily responsible for "contacts and consulting." From [redacted] through [redacted], in addition to maintaining contacts, she was the construction supervisor for [redacted]'s new office and the Human Resources Manager. From [redacted] through [redacted], her duties included, "[redacted]." In [redacted].

In the early [redacted], [redacted] worked for [redacted] as a trader and received a salary. After [redacted] years of receiving a salary, she received no compensation from [redacted]-[redacted]. [redacted] paid [redacted] non-employee compensation for her consulting services in the amounts of $[redacted], $[redacted] and $[redacted] for taxable years [redacted], [redacted] and [redacted]. In [redacted], [redacted] paid [redacted] compensation totaling $[redacted], part salary and part non-employee compensation. In [redacted], [redacted] received compensation totaling $[redacted]. According to [redacted]'s representative, [redacted] determined [redacted]'s salary and bonuses for [redacted] based on comparable salaries of [redacted] other employees who became principals of [redacted] at the same time.

Although there was no written policy in place for determining the amounts of bonuses for [redacted]'s employees, [redacted] generally paid bonuses to both its shareholder and non-shareholder employees in [redacted] and in [redacted]. The bonuses given at the end of [redacted] were usually much smaller than the bonuses given at the end of [redacted], which is also the end of [redacted] s fiscal year.

[redacted] paid the following amounts to [redacted] and [redacted] during the taxable years at issue:

[redacted]

Year	Annual Salary	Bonus	Dates of Bonus	Total
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]

[redacted]

Year	Annual Salary	1099 Misc. Compensation	Bonus	Dates of Bonus	Total
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]

From [redacted] though [redacted], [redacted]'s officers were [redacted] (vice president), [redacted] (vice president), [redacted] (vice president, secretary) and [redacted] (president, chairman).

[redacted] functioned mainly as a trader and bond salesman. He spent approximately [redacted]% of his time on sales and [redacted]% of his time on management. He retired in [redacted].

[redacted] worked as a trader. His primary duties included research and trading ([redacted]). He also spent some time on sales, portfolio management and management (approximately [redacted] on each).

[redacted] was the Chief Financial Officer and was responsible for the accounting and financial aspects of the firm. [redacted] terminated [redacted] in [redacted].

For the taxable year ending May 31, [redacted] [redacted]s officers were [redacted] (vice president), [redacted] and [redacted]. For the taxable year ending May 31, [redacted], in addition to [redacted], [redacted] and [redacted], [redacted] added [redacted] (vice chairman, executive vice president) as an officer. During fiscal year [redacted] [redacted] and [redacted] resigned, leaving [redacted] and [redacted] as the only officers.

[redacted]'s directors and officers determined their respective salaries and bonuses for each year, as set forth in the minutes of [redacted]. According to the taxpayer's representative, there was no set formula for determining their compensation. Instead, the amounts varied depending on the profitability of the company.

For the fiscal year ending May 31, [redacted] [redacted] paid the following amounts to its officers:

[redacted] [redacted]

For the fiscal year ending May 31, [redacted] [redacted] paid the following amounts to its officers:

[redacted] [redacted]

For the fiscal year ending May 31, [redacted] [redacted] paid the following amounts to its officers:

[redacted] [redacted]

For the fiscal year ending May 31, [redacted], [redacted] paid the following amounts to its officers:

[redacted]

For the fiscal year ending May 31, [redacted] [redacted] paid the following amounts to its officers:

[redacted]

For the fiscal year ending May 31, [redacted], [redacted] paid the following amounts to its officers:

[redacted]

In addition to the officers, [redacted] employed a range of [redacted] to [redacted] other employees between [redacted] and [redacted]. These employees worked as traders, assistants to traders, computer consultants, marketing and sales representatives, and in miscellaneous administrative positions.

In [redacted], [redacted] paid its [redacted] other employees compensation totaling [redacted], with an average salary of $[redacted] and an average bonus of $[redacted]. The highest-paid employee received compensation totaling $[redacted].

In [redacted], [redacted] paid its [redacted] other employees compensation totaling $[redacted], with an average salary of $[redacted] and an average bonus of $[redacted]. The highest-paid employee received compensation totaling $[redacted].

In [redacted], [redacted] paid its [redacted] other employees compensation totaling $[redacted], with an average salary of $[redacted] and an average bonus of $[redacted]. The highest-paid employee received compensation totaling $[redacted]

In [redacted], [redacted] paid its [redacted] other employees compensation totaling $[redacted], with an average salary of $[redacted] and an average bonus of $[redacted]. The highest-paid employee received compensation totaling $[redacted].

In [redacted] paid its [redacted] other employees compensation totaling $[redacted] with an average salary of $[redacted] and an average bonus of $[redacted]. The highest-paid employee received compensation totaling $[redacted].

In [redacted] paid its [redacted] other employees compensation totaling $[redacted], with an average salary of $[redacted] and an average bonus of $[redacted]. The highest-paid employee received compensation totaling $[redacted].

[redacted] has both common and preferred stock outstanding. For the taxable year ending May 31, [redacted] the common stock was owned by [redacted] ([redacted]%), [redacted] ([redacted]%), [redacted] ([redacted]%), and [redacted] ([redacted]%). For the taxable year ending May 31, [redacted] the common stock was owned by [redacted] ([redacted]%), [redacted] ([redacted]%), [redacted] ([redacted]%), and [redacted] ([redacted]%). Although we do not have specific percentages of ownership for the fiscal years ending May 31, [redacted] through May 31, [redacted], the revenue agent believes that [redacted] continued to be the majority shareholder, owning between [redacted]% to [redacted]% of the common stock, with the remaining officers owning between [redacted] to [redacted]% of the common stock. During [redacted], [redacted] was the sole shareholder. From its inception, [redacted] has never paid dividends on the common stock.

In [redacted], [redacted]'s preferred stock was owned by the following:

Owner	Number of Shares
[redacted]	[redacted]
Total	[redacted]

As of [redacted], [redacted]'s preferred stock was owned by the following:

Owner	Number of Shares
[redacted]	[redacted] [3]
Total	[redacted]

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[3] [redacted] periodically redeemed shares of preferred stock to pay [redacted] taxes.

[redacted] paid dividends on the preferred stock from [redacted] through [redacted] as follows:

Year	Amount
[redacted]	[redacted]

From [redacted] to present, [redacted] has not paid dividends on the preferred stock. When asked why [redacted] ceased paying dividends on the preferred stock, [redacted] said that the corporation needed the money to remain competitive in the market and because the "nature of the business has changed."

On its Forms 1120, [redacted] reported the following:

Fiscal Year	Total Income	Net Income[4]/ After Taxes	Year-end Retained Earnings	Year-end capital contributions[5]/
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]

Analysis

A taxpayer may deduct ordinary and necessary business expenses, including "a reasonable allowance for salaries or other compensation for personal services actually rendered." I.R.C. § 162(a)(1). See also, Rutter v. Commissioner, 853 F.2d 1267, 1270-71 (5th Cir. 1988); Owensby & Kritikos, Inc. v. Commissioner, 819 F.2d 1315, 1322-23 (5th Cir. 1987). At issue here is whether the amounts of compensation [redacted] paid to

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[4]/ As used here, the term "net income" refers to the "net income (loss) per books" as reported on the Schedules M-1 of [redacted]'s Forms 1120.

[5]/ The shareholders did not make any additional capital contributions from [redacted] through [redacted]. Instead, the amount of the capital contributions decreased each year because the [redacted] periodically redeemed preferred stock to pay [redacted] taxes.

[redacted] and [redacted] for the taxable years in question were reasonable.

The Second Circuit has considered the following five factors to determine if compensation paid by a corporation was reasonable:

> (1) The employee's role in the taxpaying company, including the employee's position, hours worked and duties performed; (2) potential conflicts of interest, such as the ability to "disguise" dividends as salary; (3) the employer's compensation policy for all employees; (4) the character and financial condition of the company; and (5) comparison of the employee's salary with those paid by similar companies for similar services.

Rapco, Inc. v. Commissioner, 85 F.3d 950, 954 (2d Cir. 1996). See also, Normandie Metal Fabricators, Inc. v. Commissioner, T.C. Memo. 2000-102. No single factor is decisive, and the court should evaluate the factors from the perspective of an independent investor, i.e., "given the dividends and return on equity enjoyed by a disinterested stockholder, would that stockholder approve the compensation paid to the employee?" Rapco, 85 F.3d at 954-55. See also, Dexsil Corp. v. Commissioner, 147 F.3d 96, 100 (2d Cir. 1998); Normandie, T.C. Memo. 2000-102.

Courts differ on the factors they consider and on the value they place on each factor. For example, in addition to the five factors set forth above, courts have considered factors such as the employee's qualifications, the size and complexity of the business, prevailing economic conditions, the amount of compensation paid to the employee in previous years and a comparison of compensation to the business' gross income and net income. See, e.g., Mayson Mfg. Co. v. Commissioner, 178 F.2d 115 (6th Cir. 1949)(considering nine factors); Kennedy, Jr. v. Commissioner, 671 F.2d 167, 73-74 (6th Cir. 1982)(considering 15 factors); Elliotts, Inc. v. Commissioner, 716 F.2d 1241 (9th Cir. 1983)(placing greater weight on fewer factors); Exacto Spring Corp. v. Commissioner, 196 F.3d 833 (7th Cir. 1999)(rejecting seven-factor test and holding that only "independent investor" test is applicable).

Because [redacted] is located in [redacted] New York, an appeal from the Tax Court would lie in the Second Circuit. Accordingly, the Tax Court would adhere to the five-factor test used by the Second Circuit in Rapco. As the Court explained, "better judicial administration requires us to follow a Court of

Appeals decision which is squarely in point where appeal from our decision lies to that Court of Appeals and to that court alone." Golsen v. Commissioner, 54 T.C. 742, 757 (1970), aff'd on another issue, 445 F.2d 985 (10th Cir. 1971)(footnotes omitted). For purposes of this memorandum, therefore, we will evaluate the reasonableness of the amounts of compensation [redacted] paid to [redacted] and [redacted] using the Second Circuit's five-factor test.

1. Employee's Role in Business

An employee's position, responsibilities, hours worked and "general importance to the success of a business" may justify his or her high level of compensation. H&A Int'l Jewelry, Ltd. v. Commissioner, T.C. Memo. 1997-467 (citing Home Interiors & Gifts, Inc. v. Commissioner, 73 T.C. 1142, 1158 (1980)).

(b)(7)a
(b)(7)a [redacted]
(b)(7)a [redacted] Note however, that "there are limits to reasonable compensation 'even for the most valuable employees.'" H&A Int'l Jewelry, T.C. Memo. 1997-467.

, (b)(7)a [redacted]

(b)(7)a [redacted].

(b)(7)a [redacted].

2. Potential Conflicts of Interest

If there are potential conflicts of interest between the corporation and the employees to whom it is paying compensation, such as the ability to disguise dividends, this suggests that the compensation is unreasonable. Rapco, 85 F.3d at 954; Normandie, T.C. Memo. 2000-102.

There are several potential conflicts of interest present here. (b)(7)a [redacted] (b)(7)a [redacted]. As the Fifth Circuit explained,

> [I]t obviously is in the tax interest of all parties to characterize the amounts distributed to shareholder/officers as compensation rather than as dividends. Corporations can deduct salaries and bonuses under § 162(a)(1) but obviously not dividend payments because they are profits, not business expenses. The concern is to prevent the distribution of corporate profits through the payment of unreasonably large salaries and bonuses to controlling shareholder/officers.

Rutter, 853 F.2d at 1270-71; see also Owensby & Kritikos, 819 F.2d at 1322-23. The amount of stock owned by a shareholder/employee is an indication of whether the employee negotiated his or her compensation at arms' length. See Northlick, Stolly, Inc. v. United States, 368 F.2d 272, 278 (Ct. Cl. 1966).

, (b)(7)a [redacted]

The taxpayer may assert that the fact that the minority shareholders approved [redacted]s compensation suggests that his compensation was reasonable. See Heitz v. Commissioner, T.C. Memo. 1998-220, revs'd on other grounds, sub nom, Exacto Spring Corp. v. Commissioner, 196 F.3d 833 (7th Cir. 1999) (explaining that the approval of the president's compensation by minority shareholders weighs in favor of reasonableness of compensation, where minority shareholders "did not receive a substantial dividend or some other benefit as well."). Here, , (b)(7)a [redacted].

Second, , (b)(7)a [redacted]. Rapco, 85 F.3d at 955. [redacted] (b)(7)a [redacted].

Third, (b)(7)a [redacted]. Normandie, T.C. Memo. 2000-102. See also, Petro-Chem Mktg. Co. v. United States, 602 F.2d 959, 968 (Ct. Cl. 1979); Owensby & Kritikos, 819 F.2d at 1329; Estate of Wallace v. Commissioner, 95 T.C. 525, 555-56

(1990), aff'd, 965 F.2d 1038 (11th Cir. 1992). [redacted].

Fourth, [redacted]. Cf. Owensby & Kritikos, 819 F.2d at 1327-28 (explaining that reasonable, longstanding and consistently applied formula for compensation will support a determination that the compensation is reasonable).

[redacted]." Dexsil, 147 F.3d at 101.

[redacted].

3. Internal Consistency in Compensation

Courts look to the internal compensation policies relating to non-shareholder employees to determine whether the corporation has compensated its shareholders more favorably because of their ownership interests. H&A Int'l Jewelry, T.C. Memo. 1997-467. If an employer consistently pays its non-shareholder employees generously, this will support the reasonableness of the compensation paid to the shareholder employee. See Home Interiors & Gifts, 73 T.C. at 1162. If, however, an employer pays its non-shareholder employees conservatively, this weighs against the reasonableness of the compensation paid to the shareholder employee. See Standard Asbestos Mfg. & Insulating Co. v. Commissioner, 276 F.2d 289, 293 (8th Cir. 1960).

In [redacted]

, (b)(7)a [redacted]'s [redacted].

(b)(7)a [redacted]

[redacted] , (b)(7)a [redacted].

(b)(7)a [redacted]

(b)(7)a [redacted].

4. <u>Character and Financial Condition of</u> [redacted]

The character and financial condition of [redacted] has a bearing on whether the compensation [redacted] paid to [redacted] and [redacted] was reasonable. If the company is in good financial condition, then an independent investor would likely support [redacted]'s payment of high compensation. <u>Normandie</u>, T.C. Memo. 2000-102. The character and financial condition of a company can be evaluated based on a company's "sales, net income, capital value, and general economic fitness." <u>Id.</u>

(b)(7)a [redacted]

Many courts examining this issue have evaluated the financial condition of a business based on the shareholder's return on equity for each year involved. See, e.g., Universal Mfg. Co., Inc. v. Commissioner, T.C. Memo. 1994-367; H&A Int'l Jewelry, T.C. Memo. 1997-467; Alpha Medical v. Commissioner, T.C. Memo. 1997-464, revs'd on other grounds, 172 F.3d 942 (6th Cir. 1999). (b)(7)a [redacted].

(b)(7)a [redacted]." Normandie, T.C. Memo. 2000-102.

In addition, a corporation's failure to pay dividends may also suggest that the compensation it paid to a shareholder was unreasonable, when the compensation greatly decreases the corporation's rate of return for an independent investor. Elliotts, Inc., 716 F.2d at 1245; Automotive Investment Development, Inc. v. Commissioner, T.C. Memo. 1993-298. If a corporation does have a legitimate purpose for retaining large earnings, such as planned capital improvement or future growth, then its failure to pay dividends may not have any bearing on the reasonableness of the compensation. Owensby & Kritikos, 819 F.2d at 1326; Automotive Investment, T.C. Memo. 1993-298.

(b)(7)a [redacted].

, (b)(7)a [redacted].

(b)(7)a [redacted].

5. <u>Comparison of Compensation with Similar Companies</u>

Whether the compensation [redacted] paid to [redacted] and [redacted] is reasonable also depends on the compensation similar companies pay to employees in similar positions with similar responsibilities. <u>See</u> Treas. Reg. § 1.162-7(b)(3); <u>Rapco</u>, 85 F.3d at 954; <u>Rutter</u>, 853 F.2d at 1271; <u>Mayson</u>, 178 F.2d at 199; <u>Normandie</u>, T.C. Memo. 2000-102. (b)(7)a [redacted].

[redacted], (b)(7)a [redacted]. "

(b)(7)a [redacted].

(b)(7)a [redacted], [redacted].

<u>Conclusion</u>

(b)(7)a [redacted], [redacted].

If you have any questions, please contact the undersigned at (212) 264-5473, extension 292, or Robin L. Peacock at (212) 264-1595, extension 289.

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